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Nos. 370 and 383

# In the Supreme Court of the United States

October Term, 1944

Colorado Interstate Gas Company, a Corporation, Petitioner,

v.

Federal Power Commission, City and County of Denver, Colorado, Public Service Commission of Wyoming, Colorado-Wyoming Gas Company, Public Service Company of Colorado, and Canadian River Gas Company

Canadian River Gas Company, a Corporation, Petitioner,

v.

Federal Power Commission, City and County of Denver, Colorado, Public Service Commission of Wyoming, Colorado-Wyoming Gas Company, Public Service Company of Colorado, and Colorado Interstate Gas Company

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION, CITY AND COUNTY OF DENVER, COLORADO, AND PUBLIC SERVICE COMMISSION OF WYOMING

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*v.*

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CANADIAN RIVER GAS COMPANY, A CORPORATION, PETITIONER

*v.*

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*ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT*

## BRIEF FOR THE FEDERAL POWER COMMISSION, CITY AND COUNTY OF DENVER, COLORADO, AND PUBLIC SERVICE COMMISSION OF WYOMING[1]

### OPINIONS BELOW

The opinion and orders of the Federal Power Commission (R. I, 140–192) are reported in 43 P. U. R. (N. S.) 205. The opinion of the circuit court of appeals (R. VIII, 5066–5094) is reported in 142 F. (2d) 943.

### JURISDICTION

The judgment of the circuit court of appeals was entered July 8, 1944 (R. VIII, 5094). The petitions for writs of certiorari were filed on August 22, 1944. Writs of certiorari were granted on November 13, 1944, limited to Questions Nos. 5 and 6 presented in the petition in No. 379 and to Question No. 8 presented in the petition in No. 380. By order entered January 2, 1945, the scope of review in No. 380 was enlarged to include Questions Nos. 1, 2 and 3 presented in the petition. Jurisdiction of this Court

[1] Although Nos. 379 and 380 present for review two separate orders of the Commission, those orders were entered in a consolidated proceeding instituted upon complaints filed with respect to both companies. The cases were heard on a single record both before the Commission and before the court below, and were disposed of in a single opinion in that court. Moreover, the issue to which review was limited by the original orders of this Court granting certiorari is common to both cases. For these reasons, it has appeared appropriate to deal with both cases in a single brief.

rests upon Section 19 (b) of the Natural Gas Act, and Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTIONS PRESENTED

The questions as to which a writ of certiorari was granted in No. 379, as stated in the petition in that case, are as follows:

> "5. Whether consistently with the requirements of the Fifth Amendment to the Constitution of the United States and the Natural Gas Act the Commission could determine reasonable rates for gas sold for resale in interstate commerce without making a separation or allocation of the property of Canadian and petitioner which, in this case, is used in making intrastate sales in Texas and interstate sale of both resale and direct sale gas, the Commission having no jurisdiction over intrastate sales or over direct sales in interstate commerce to industrial consumers.
>
> "6. Whether the Commission's substitute method of allocation of cost of service which results in burdening non-regulable gas with costs actually chargeable against regulable gas violates the Fifth Amendment to the Constitution of the United States and the Natural Gas Act."

The questions as to which a writ of certiorari was granted in No. 380, as stated in the petition in that case, are as follows:

"1. Whether the Circuit Court, after correctly holding that the Commission has no rate regulatory jurisdiction over Canadian's production and gathering properties, facilities and business, erroneously concluded and ruled that the Commission in this case did not exercise such prohibited jurisdiction."

"2. Whether, even assuming, *arguendo*, that the Commission has rate regulatory jurisdiction over Canadian's production and gathering properties, facilities and business, the Commission can, consistently with the Fifth Amendment to the Constitution of the United States, the requirements of the Act, and the decisions of this Court in the Natural Gas Pipeline, Hope and other cases, limit Canadian generally to a return only on the 'wildcat' or original cost of its gas leaseholds to predecessor companies prior to discovery and development over 20 years ago, to the exclusion of all evidence of value, market or otherwise, the result of this procedure being, among other things, the inclusion in the Commission's rate base of a substantial block of Canadian's most valuable leaseholds at zero valuation and a still larger block of valuable leaseholds at only 10¢ per acre valuation."

"3. Whether, even assuming, *arguendo*, that the Commission has rate regulatory jurisdiction over Canadian's production and gathering properties, facilities and business, and further assuming, *arguendo*, that it is proper in this case to include Canadian's leaseholds and wells in the rate base on the basis of original cost, the Commission can, consistently with the Fifth Amendment to the Constitution of the United States, the requirements of the Act, and the principles announced by this Court in the Natural Gas Pipeline, Hope and other cases, disallow and eliminate more than $3,000,000, plus interest during construction paid thereon, from the amount actually invested by Canadian in its original acquisition of production properties in about 1928 solely upon the ground that the sum so eliminated allegedly represented a profit between affiliated companies, and, therefore, formed no proper part of the cost of said properties, where the Record clearly demonstrates that the transaction resulting in the acquisition of said properties was not between affiliates and that the price paid therefor was not excessive."

"8. Whether the Commission can, consistently with the Fifth Amendment to the Constitution of the United States and the provisions of the Act, reduce the rates and charges of Canadian on that part of its

natural gas sales to Colorado Interstate which is not sold by the latter for ultimate distribution to the public but is sold by it directly to its industrial customers; furthermore, independent of the above question, whether the Commission erred in making no separation or allocation as between Canadian's properties devoted to intrastate sales in Texas and its properties devoted to interstate sales, or as between the properties of Canadian and the properties of Colorado Interstate, and in using in lieu thereof a substitute method of allocation of cost of service which results in burdening non-regulable gas with costs actually chargeable against regulable gas, in violation of the Fifth Amendment to the Constitution of the United States and the Act."

## STATUTES INVOLVED

The applicable portions of the Natural Gas Act are set forth in Appendix A, *infra*, pp. 89–104.

## STATEMENT

The proceedings before the Commission arose out of a complaint filed on December 22, 1938, by the City and County of Denver, Colorado, against Public Service Company of Colorado, and petitioners, Colorado Interstate Gas Company ("Colorado") and Canadian River Gas Company ("Canadian"), alleging that the rates charged

by Colorado for natural gas purchased from Canadian and sold to Public Service Company of Colorado for resale in Denver were excessive, unreasonable, unjust, and discriminatory (R. I, 302). On January 9, 1939, the Public Service Commission of Wyoming filed a complaint with the Commission alleging that the rates of Canadian and Colorado for natural gas sold to Colorado-Wyoming Gas Company for resale to Cheyenne Light, Fuel and Power Company, which distributes such gas in Cheyenne, Wyoming, were unjust, unreasonable, and discriminatory (R. I, 333). The Commission, on its own motion, instituted an investigation, on March 14, 1939, of all interstate wholesale rates and charges of petitioners, Colorado and Canadian, and of Colorado-Wyoming Gas Company (R. I, 317).

Hearings on the complaints and the investigation were consolidated by the Commission, begun on October 28, 1940, and held on 102 days (R. I, 141). After submission of briefs, the Commission, on March 18, 1942, issued its opinion and

On April 12, 1939, petitioners filed with the Commission a joint application praying for a stay of the order instituting the investigation, which the Commission denied by order dated May 9, 1939. A petition to review the latter order was dismissed by the Circuit Court of Appeals for the Tenth Circuit in *Canadian River Gas Company, et al. v. Federal Power Commission*, 110 F. (2d) 350, rehearing denied, 113 F. (2d) 1010, certiorari denied, 311 U. S. 693.

orders here under review, finding that the interstate wholesale rates of Canadian were excessive by $561,000 per year and those of Colorado by $2,065,000 per year, and requiring petitioners to reduce such rates accordingly (R. I, 185–192).[3] The following facts, found by the Commission, are clearly established by the evidence:

*The Petitioners.*—Canadian and Colorado were incorporated and financed, and are operated, pursuant to an agreement dated April 5, 1927, between Southwestern Development Company ("Southwestern"), Standard Oil Company (N. J.) ("Standard") and Cities Service Company ("Cities Service") (R. I, 381–401). By this agreement Southwestern, Standard and Cities Service pooled their respective gas reserves, finances and distribution markets, to bring natural gas from the Panhandle field to the Denver and Pueblo, Colorado, markets. This pooling was effected in the following manner:

Southwestern, through a wholly owned subsidiary, Amarillo Oil Company ("Amarillo"), controlled certain gas leaseholds and producing properties in the Texas Panhandle field, which Southwestern agreed to transfer to a new sub-

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[3] Canadian's reduction includes $551,000 which is applicable to its sales to Colorado, and the portion of this amount allocated to Colorado's interstate sales for resale is included in the $2,065,000 reduction prescribed for Colorado (R. I, 176, 177).

sidiary (Canadian) which it would organize for that purpose (R. I, 381–382). Standard agreed to form a new corporation (Colorado) and to finance its construction of pipeline facilities to connect with and transport gas from Canadian's facilities to the Denver market and intermediate points including Pueblo (R. I, 385). Cities Service was to procure franchises through its subsidiaries under which such natural gas could be distributed in Denver and Pueblo (R. I, 391). It was agreed that Canadian would sell gas to Colorado at "cost" for at least 20 years from 1928, such "cost" to include amortization of all of Canadian's indebtedness over the twenty-year period and to be decreased by any profits Canadian might obtain from other sources, including local sales permitted by Colorado (R. I, 392; R. II 719–732). Canadian, under the "cost" contract, would have nothing available for dividends on its common stock during the first 20 years (R. III, 1436) and so long thereafter as Colorado might choose to purchase its gas at "cost" (R. III, 1435).

Pursuant to the agreement, Southwestern organized Canadian, to which were transferred the gas leaseholds and producing properties of Amarillo, also a wholly-owned subsidiary of Southwestern. The cash consideration for this transfer was \$5,000,000, stipulated in the tripartite agreement and advanced by Standard for this purpose at

6% interest (R. I, 392, R. V, 2936-2937).[1] To repay the advance and to finance the acquisition and construction of additional facilities, Canadian issued $11,000,000 of twenty-year 6% sinking fund bonds, which Colorado purchased from the proceeds of its $19,200,000 of twenty-year 6% sinking fund bonds, which, in turn, were purchased by Standard, in accordance with the 1927 agreement (R. I, 496).

As had been further agreed, Standard organized Colorado with $2,000,000 par value of 6% preferred stock and 1,250,000 shares of no par common stock, and paid $1,000,000 in cash for half of the preferred stock and another $1,000,000 in cash for its portion (42½%) of Colorado's common stock (R. II, 626). Southwestern also received half of Colorado's preferred stock and 42½% of the common stock (R. II, 626), the remaining 15% of the common stock being issued to Cities Service (R. I, 395-396, R. II, 627). It was implicit in the tripartite agreement, therefore, that Southwestern, Standard, and Cities Service would receive their profits from the operations of the enterprise by way of dividends on Colorado's stock.

*The Commission's Orders.*—In requiring Canadian to reduce its interstate wholesale rates

[1] As hereinafter discussed, *infra*, pp. 37-53, the Commission in determining Canadian's rate base, disallowed the $3,249,030 portion of this amount which was in excess of the $1,750,970 cost of such properties to Amarillo and its affiliates.

by $561,000 annually, the Commission found the actual legitimate cost of the company's plant at December 31, 1939, to be $10,784,464 (R. I, 186). From this amount it deducted $2,134,629 for accrued depreciation and depletion as of that date, and added $150,738 for working capital and $571,-923 covering gross plant additions to December 31, 1941. This resulted in a rate base of $9,372,-496, which was rounded to $9,375,000 (R. I, 187). In requiring Colorado to reduce its interstate wholesale rates by $2,065,000 annually, the Commission found the actual legitimate cost of the company's plant at December 31, 1939, to be $11,879,409 (R. I, 190). From this amount it deducted $2,793,410 for accrued depreciation and amortization as of that date; and added $109,065 for working capital and $337,000 covering gross plant additions to December 31, 1941. This resulted in a rate base of $9,532,064, which was rounded to $9,535,000 (R. I, 190). Petitioners' estimates of reproduction cost were considered by the Commission and were found to be too conjectural to have probative value (R. I, 148). The Commission further found that actual costs, which could be readily determined from petitioners' accounting records, represented the best and only reliable evidence as to rate base (R. I, 148).

The Commission allowed a 6½% return on the rate base of each petitioner, which return it found to be "fair and reasonable" (R. I, 187, 190), noting that Colorado in 1940 had refinanced its

outstanding bonded indebtedness at an interest rate of 2¾% (R. I, 173). With certain minor exceptions, the Commission allowed each petitioner the taxes, operating expenses, exploration and development costs, shown by its books for the test year, 1939, adjusted to reflect accrual accounting (R. I, 166-169; R. VI, 3387). The Commission also allowed amounts to amortize rate case expenses over a five-year period (R. I, 166, 168). Annual allowances for depreciation, depletion and amortization were determined on the basis of the economic service lives of petitioners' properties, such allowances being consistent with the amounts deducted for accrued depreciation, depletion and amortization in arriving at the rate bases (R. I, 160, 156).

In arriving at the amount of the reductions in the interstate wholesale rates, the Commission made an allocation of the cost of service of each petitioner, including in such cost the fair return on the rate base, and determined the excess of revenues over costs for intrastate sales, direct industrial sales, and interstate sales for resale (R. I, 176-177).

The petitioners, on April 14, 1942, applied for a rehearing and stay of the Commission's orders (R. I, 203, 238, 277, 284), and on May 13, 1942, the Commission issued its supplemental opinion and orders denying such petitions (R. I, 296-301). On review the court below affirmed the Commission's orders (R. VIII, 5065-5094).

## SUMMARY OF ARGUMENT

### I.

The action of the Commission in reflecting Canadian's production and gathering facilities in the rate base at cost and then limiting Canadian's return to 6½% was not a regulation of "production or gathering" forbidden by Section 1 (b) of the Act. That section withholds from the regulatory authority of the Commission the *activity* of producing or gathering natural gas, but there is nothing therein to indicate a Congressional intent to preclude the Commission from considering either such facilities in calculating the rate base or the expenses incident thereto for the purpose of determining the reasonableness of the interstate wholesale rates. *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. 591, 614, n. 25. The legislative history of the Act confirms this view. The Committee report, after stating that the negative language in Section 1 (b) was largely surplusage, also stated that the Act contemplated regulation along "more or less standardized lines". The valuation of production and gathering facilities historically has been an integral part of the regulatory rate fixing procedure. *Dayton Power & Light Co.* v. *Commission*, 292 U. S. 290.

Sections 6 (a), 6 (b), 8 (a), 9 (a), and 10 (a) of the Act all contain language authorizing the Commission to ascertain the costs of production and

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gathering facilities. The language and legislative history of Section 14 (b) confirm the view that the Commission is required to investigate such costs. The uniform administrative interpretation of the Commission consistently has been to consider production and gathering facilities in fixing the rate base and the Commission has so reported to Congress. Finally, legislative approval of the administrative interpretation may be inferred from the fact that when Section 7 was amended in 1942, no legislative change was made in respect of this matter although the Commission's administration of the Act was thoroughly reviewed.

## II

The Commission's failure to allow a market value for Canadian's leaseholds in the rate base as well as its refusal to allow a "field" or "commodity" price for natural gas which Canadian produces was not a deprivation of due process. Canadian's contention to the contrary is inconsistent. If the Commission lacked jurisdiction over production and gathering facilities, the inclusion of leaseholds in the rate base at their market value would not confer jurisdiction. If it had jurisdiction, it is a matter for the informed judgment of the Commission to select the appropriate basis for reflecting the leaseholds in the rate base. Evidence of market value of the character submitted by Canadian is not compelling or even persuasive. *Dayton Power & Light Co.* v. *Commission*, 292 U. S. 290, 296–301.

Canadian's evidence of field or commodity price of gas as an alternative measure of the value of its leaseholds is open to the same objections. This is particularly true of the Panhandle field where the available gas geratly exceeds demands. The only substantial market is that furnished by the large pipelines which fix their own prices, and to speak of commodity value in such circumstances is unrealistic. This Court has recognized the peculiar situation which there obtains in *Thompson* v. *Consolidated Gas Co.*, 300 U. S. 55. The cost system adopted by the Commission on the other hand is just to consumers and pipelines alike. It considers costs as best calculated to insure continuity in the production of natural gas and the financial soundness of the pipelines themselves. The fact that it has become possible to finance such enterprises at progressively lower rates discloses that the investing public appreciates the ultimate soundness of the Commission's approach.

III

In respect of the leaseholds the Commission properly allowed the $1,750,000 cost of such properties to Amarillo and rejected Canadian's claim that $5,000,000 represented the "price" which it paid in acquiring these properties from Amarillo. There was no actual purchase or sale of the properties, which Southwestern merely transferred from one of its wholly-owned subsidiaries

(Amarillo) to another (Canadian). The alleged "purchase price" of \$5,000,000 came from the proceeds of bonds issued by Canadian and did not represent any additional investment in the properties. In reflecting the so-called "payment" on their books, the parties recognized the true nature of the "purely intercompany profit" which the Commission has disallowed, and neither Southwestern, Amarillo, nor Canadian paid any income tax as a result of the so-called "sale".

Viewed from the standpoint of Standard and Cities Service, the \$5,000,000 represented an advance of part of Southwestern's portion of the profits of the project. This amount is no more a part of the rate base than the dividends on Southwestern's stock holdings in Colorado Interstate. While Southwestern, Standard and Cities Service may have bargained extensively as to the distribution between them of the profits of the joint enterprise, such profits are not part of the rate base, even though one of the parties (Southwestern) received a portion (\$5,000,000) of its share in advance because of its poor financial condition.

IV

In determining the amount of the reductions in petitioners' interstate wholesale rates, the Commission made an appropriate allocation of the cost of service between petitioners' regulable and non-

regulable sales. The Commission was not required, under the Constitution, the Act or the prior decisions of this Court, to take the preliminary step of first allocating the physical properties. Use of the established "commodity-demand" method of allocation represented a reasonable exercise of the Commission's administrative discretion in the circumstances.

V

All of the gas which Canadian sells to Colorado Interstate is sold "for resale" in interstate commerce and the rate charged therefor is subject to regulation by the Commission. As the provisions of Section 1 (b) of the Act and its legislative history make clear, the fact that Colorado Interstate sells a portion of such gas directly to industrial customers, rather than for resale, is not material in determining which of Canadian's rates are subject to the Commission's jurisdiction.

ARGUMENT

I

THE COMMISSION DID NOT EXCEED ITS JURISDICTION WITH RESPECT TO CANADIAN'S PRODUCING AND GATHERING FACILITIES

Canadian contends that the Commission, contrary to Section 1 (b) of the Act which makes the provisions thereof inapplicable to the "production or gathering of natural gas", exercised

rate regulatory authority over its production and gathering facilities by reflecting such properties in the rate base at cost and then limiting Canadian's return to 6½% (Can. Br. 14–19). It also urges that, in fixing rates, the Commission should determine the commodity or field price of gas (Can. Br. 21). While it is of course clear under Section 1 (b) of the Act that the Commission has no jurisdiction to regulate "production and gathering" as such, the Commission, in determining the reasonableness of a natural gas company's interstate wholesale rates, properly reflects its production and gathering facilities in the rate base, and properly considers the expenses, including depletion, applicable to such properties. We submit that there is no merit to Canadian's contention in this respect. *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. 591, 614, n. 25. This is apparent from the purposes and provisions of the Natural Gas Act, as well as its legislative history.

Section 1 (a) of the Natural Gas Act declares that "Federal regulation *in matters relating to* the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest" (emphasis supplied), and in accordance with this declaration of policy, Section 1 (b) provides that the Act "shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of

natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale."

The above quoted provision in Section 1 (b), considered alone, clearly vests the Commission with jurisdiction over the production and gathering facilities of a natural gas company. Canadian contends, however, that the Act as a whole indicates that Congress intended to exclude from regulation the production and gathering phase of the business of a natural gas company. In support of this contention Canadian principally relies upon the "but" clause in Section 1 (b), which specifies that the provisions of the Act "shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or *to the production or gathering of natural gas*" (emphasis supplied).

At the outset, it may be conceded that Section 1 (b) withholds from the regulatory power of the Commission the *activity* of producing or gathering natural gas, and that accordingly the Commission has no authority over such matters as, for example, the determination of the drilling or spacing of wells in the field, the number of wells to be drilled in a common reservoir, proration of the production of oil or gas, or cycling or other recovery operations. However broad

may be the catalogue of activities thus excluded from the Commission's jurisdiction, we submit that there is no warrant for assuming that Congress, by excluding such activities, intended to preclude the Commission from reflecting the production and gathering facilities of a natural gas company in the rate base and considering the expenses incident thereto for the purpose of determining the reasonableness of interstate wholesale rates under the Act.

The legislative history confirms the fact that the "but" clause in Section 1 (b) does not remove from the Commission's jurisdiction what would otherwise be subject thereto by reason of its authority over the transportation and sale of natural gas in interstate commerce for resale under the first part of Section 1 (b). Thus, the House Committee on Interstate and Foreign Commerce in reporting the bill (H. R. 6586, 75th Cong., 1st Sess.) which became the Natural Gas Act, quoted the "but" clause in its report (H. Rep. No. 709, 75th Cong., 1st Sess., p. 3) and then stated:

> "*The quoted words are not actually necessary,* as the matters specified therein could not be said fairly to be covered by the language affirmatively stating the jurisdiction of the Commission, but similar language was in previous bills, and, rather than invite the contention, however unfounded, that the elimination of the nega-

tive language would broaden the scope of the act, the committee has included it in this bill. That part of the negative declaration stating that the act shall not apply to 'the local distribution of natural gas' *is surplusage* by reason of the fact that distribution is made only to consumers in connection with sales, and since no jurisdiction is given to the Commission to regulate sales to consumers the Commission would have no authority over distribution, whether or not local in character." [Emphasis supplied.]

Section 5 (a) of the Act places the duty upon the Commission to determine "the just and reasonable rate, charge * * * to be thereafter observed and in force, and * * * fix the same by order." In both *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, and *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. 591, the Commission, without challenge by either the natural gas companies or this Court, included the production and gathering facilities in the rate base on which a return was allowed. Indeed, in the *Hope* case, this Court observed (320 U. S. at 616) that the Natural Gas Act contemplated "regulation along recognized and more or less standardized lines", citing H. Rep. 709, *supra*, p. 3. The valuation of production and gathering facilities historically has been

an integral part of the regulatory procedure in fixing rates for natural gas. *Dayton Power & Light Co.* v. *Commission*, 292 U. S. 290; *Lone Star Gas Co.* v. *Texas*, 304 U. S. 224.

There are numerous provisions in the Natural Gas Act which clearly indicate that the Commission has jurisdiction over the production and gathering properties of a natural gas company to the extent necessary to carry out its functions under the Act, and particularly its principal function of determining the reasonableness of the company's interstate wholesale rates. Thus, Section 6 (a) authorizes the Commission to "investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property." Section 6 (b) requires every natural gas company, upon request, to file with the Commission "an inventory of all or any part of its property and a statement of the original cost thereof." It will be noted that Section 6, which is directly related to the Commission's rate-making powers, extends to all the property of a natural gas company. Similarly, Section 8 (a), in authorizing the Commission to prescribe uniform and correct accounting for natural gas companies, extends to all the property of such

companies.[5] And under Section 9 (a), the Commission is authorized to determine and to fix by order the proper and adequate rates of depreciation and amortization "of the several classes of property of each natural-gas company used or useful in the production, transportation, or sale of natural gas." That the Commission's authority under this section is directly related to its rate-making powers is indicated by the proviso that nothing in that section shall limit the power of a state commission to determine the rates of depreciation or amortization to be allowed for the purpose of determining rates or charges subject to state regulation. Under Section 10 (a) the Commission is authorized to require natural gas companies to file reports giving full information as to assets and liabilities as well as the cost of maintenance and operation "of facilities for the production, transportation, or sale of natural gas."[6]

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[5] Section 8 (a) of the Natural Gas Act is identical with and was taken from Section 301 (a) of the Federal Power Act. In reporting out the latter, the Senate Committee on Interstate Commerce stated (S. Rep. No. 621, 74th Cong., 1st Sess., p. 53) that "the authority of the Commission over the accounts of companies under its jurisdiction extends to the entire business of such companies."

[6] Section 5 (b) further provides that the Commission "may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas."

The conclusion that Congress contemplated that the Commission would consider the production and gathering properties of a natural gas company in determining interstate wholesale rates, is reinforced by the provisions and legislative history of Section 14 (b) of the Act. That section authorizes the Commission, after hearing, to determine the adequacy or inadequacy of the gas reserves of natural gas companies and, also after hearing, to "determine the propriety and reasonableness of the inclusion in operating expenses, capital, or surplus of all delay rentals or other forms of rental or compensation for unoperated lands and leases." The section further provides that the Commission, for purposes of such determinations, may require each natural gas company to file copies of "all its lease and royalty agreements with respect to such gas reserves."

The direct relation of Section 14 (b) to the Commission's rate making authority is clearly indicated by its legislative history. As introduced, the bill (H. R. 4008, 75th Cong., 1st Sess.) which, as amended (H. R. 6586, 75th Cong., 1st Sess.), became the Natural Gas Act, did not contain the provisions of Section 14 (b).[7] In the hearings before the House Committee the National Secretary of the Cities Alliance urged that

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[7] The provisions of Section 14 (b) were contained in another bill (H. R. 5711, 75th Cong., 1st Sess.) which the Committee then had before it in addition to H. R. 4008.

the provisions of Section 14 (b) be added to the bill, "to prevent great pipe line corporations from acquiring more acreage than is necessary to supply the consuming public which it serves, and so far as the proposed amendment is concerned, would keep them from passing on the charge of carrying that property to the consuming public." He recognized that he could not ask the Committee "to go so far as to prevent them from making the purchase, if they want to, but we can ask that provision can be made whereby the Commission can see that the cost of carrying those excess acres, that are not necessary in the public interest, shall not be taken into consideration in passing upon the question of what are proper rates to be charged the consuming public." (Hearings on H. R. 4008, 75th Cong., 1st Sess., pp. 60, 67, 84).

The purpose of Section 14 (b) is further apparent from the testimony of Mr. William A. Dougherty before the Committee. Mr. Dougherty, who identified himself as a New York attorney connected with the management of certain natural gas pipe-line companies, including Colorado Interstate Gas Company, which he named (Hearings, p. 123), objected to the proposed amendment because of the additional expense which would be involved in filing copies of all leases and royalty agreements. He contended that such a requirement was "not necessary" since the

"only purpose of having information on lease and royalty agreements is when you are determining a rate and when you are going to determine a rate you can have those things brought in" (Hearings, p. 131). Mr. Dougherty further stated that careful consideration should be given to the provisions of the proposed amendment authorizing the Commission to determine the adequacy or inadequacy of gas reserves, and pointed out that "the Commission can exclude carrying charges of vast amounts of reserves as charges that have no immediate bearing on the immediate rate" (Hearings, p. 132). He added that "the law already gives the Commission the right to exclude delay rentals if the Commission feels that the reserve for which the delay rentals are included are too extensive, and I think the Commission would have that right even without this wording with respect to determining the adequacy or the inadequacy of gas reserves" (Hearings, pp. 132–133).

The hearings which the House Committee on Interstate and Foreign Commerce held on the first predecessor bill (H. R. 11662, 74th Cong., 2nd Sess.) which was reported out (H. Rep. 2651, 74th Cong., 2nd Sess.) also confirm the Commission's view. There the then Solicitor of the Federal Power Commission, Dozier A. DeVane, agreed with a member of the committee that the Commission "would go into all the great natural gas

fields of this country to determine costs" and "ascertain the cost of generating plant, and all the facilities, and, of course, build up a proper foundation for your rate finally to be sustained" as was done under Title II of the Federal Power Act (Hearings, pp. 31–32).

In addition, the Commission's administrative interpretation of the Act in this connection is of particular significance since it has been impliedly approved by Congress. The Commission in determining the reasonableness of interstate wholesale rates has consistently reflected the company's production and gathering facilities in the rate base.[8] This administrative interpretation of the Act was brought to the attention of Congress in the Commission's Twentieth Annual Report for the year 1940, which summarized the Commission's work in connection with major rate cases and in so doing, stated (p. 77):

> "*Gas reserves.*—As the natural-gas industry is an extractive industry, *one of the important elements of cost which must be determined pertains to the exhaustion of the service life of the properties due to the*

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[8] *Illinois Commerce Comm. v. Natural Gas Pipeline Co.*, 25 P. U. R. (N. S.) 41, affirmed 315 U. S. 575; *Re Lone Star Gas Co.*, Order of May 4, 1942, in Docket No. G-209; *Cleveland v. Hope Natural Gas Co.*, 44 P. U. R. (N. S.) 1, affirmed 320 U. S. 591; *Re El Paso Natural Gas Co.*, Order of October 29, 1942, in Docket No. G-257; *Re Northern Natural Gas Co.*, 47 P. U. R. (N. S.) 74.

*depletion of the natural-gas reserves which the properties were constructed to produce or transport.* The Commission's geologists have been engaged in estimating the volume of gas reserves in a number of important fields, among them the Panhandle field in Texas, the Hugoton field in Kansas and a major portion of the fields located in West Virginia, Pennsylvania, and New York. A few years' difference in the estimated life of available gas reserves supplying a given market may *make a large difference in the rates* which can be justified for that area." [9] [Emphasis supplied.]

Soon after this report was submitted, the House Committee on Interstate and Foreign Commerce held hearings on a bill (H. R. 5249, 77th Cong., 1st Sess.) to amend Section 7 of the Natural Gas Act to broaden the Commission's jurisdiction with respect to certificates of public convenience and necessity. Following extensive hearings, during which the Commission's administration of the Act was fully explored (see Hearings, pp. 34–35, 40–46, 60–61), the bill was favorably reported and enacted on February 7, 1942.

[9] The report also pointed out that the Commission's staff, in connection with the organization of natural gas rate cases "along the lines indicated", had made four comprehensive field investigations, including the "Canadian River Gas Co., Colorado Interstate Gas Co., and Colorado-Wyoming Gas Co. in the Mid-West," the proceedings now under review in Nos. 370, 380 and 575, this Term.

We accordingly submit that the Commission had jurisdiction to reflect Canadian's producing and gathering facilities in its rate base, and to consider the expenses incident thereto in determining the reasonableness of its interstate wholesale rates.

## II

### THE COMMISSION PROPERLY DECLINED TO ALLOW CANADIAN THE ALLEGED MARKET VALUE OF ITS LEASEHOLDS OR A "COMMODITY" OR FIELD PRICE FOR ITS GAS

Assuming *arguendo* that the Commission did not exceed its jurisdiction in reflecting Canadian's production and gathering facilities in the rate base, Canadian nevertheless contends (Can. Br. 19–21) that it was deprived of its property without due process of law by reason of the Commission's refusal to be guided by evidence in the record as to the value of its leaseholds as of the time of the hearing. The alleged market value of the leaseholds was the subject of evidence presented by one of Canadian's witnesses, Wallace (Ex. 181; R. VI, 3181–3254). Although it is not entirely clear from Canadian's brief, it would seem (Can. Br. 20–21) that Canadian's position is that its rights would have been satisfied if the Commission had either accepted Wallace's conclusions as to the market value of the leaseholds, or, as an alternative, accepted as a measure of such market value the evidence of Canadian's witness

Ford (R. VI, 3255–3281) as to the market value of gas at the wellhead. We are unable to perceive the force of Canadian's contention in this respect. If the Commission has no jurisdiction over production and gathering facilities, the inclusion of such facilities at some particular value, however computed, could not avail to confer such jurisdiction. And if the Commission has jurisdiction, the selection of the appropriate method for determining the rate base and costs, as between several methods equally available in the particular case, is clearly a question for the expert judgment of the Commission, which is not to be overruled merely because it failed to select a method which would have produced a result more advantageous to the natural gas company involved. In this case both the alternative methods proposed by Canadian contain inherent defects and qualities of unreliability which fully justified the Commission in rejecting them, and in reflecting Canadian's production and gathering facilities in the rate base at their actual legitimate cost.

The evidence as to market value sought to establish a current value in excess of $15,000,000 for "the bare gas leaseholds themselves" (Can. Br. 20).[10] This evidence, however, was no more

[10] It is not the fact, as Canadian states (Can. Br. 20), that the Commission included "Canadian's bare leaseholds . . . at a value of something less than $1,000,000." $2,194,841 was included for lease costs. After deducting $252,006 for accrued depletion, the Commission allowed $1,942,835 as net invest-

than opinion evidence of a single witness who endeavored to reflect the assumed "value" from the demand for gas by Canadian's customers and the construction of pipeline facilities to serve them. Such "value" was also enhanced by the benefits of conservation legislation. Just such testimony was condemned, in the words of Mr. Justice Cardozo, in *Dayton Power & Light Co. v. Commission*, 292 U. S. 290, at 299:

> "* * * But plainly opinions thus offered, even if entitled to some weight, have no such conclusive force that there is error of law in refusing to follow them. This is true of opinion evidence generally, whether addressed to a jury [cases cited] or to a judge [cases cited] or to a statutory board [cases cited]. There are reasons why the principle has special application here. In the first place, the intrinsic value of the leases is dependent upon the capacity of the lands to yield productive wells, a capacity seldom to be judged with even a fair approach to certainty until tested by experience. *Natural Gas Co. of W. Va. v. Public Service Comm.*, 95 W. Va. 557, 569, 121 S. E. 716. In the second place, the profits

ment. In addition, $40,453 of the amount allowed in the rate base for interest during construction related to the lease investment. Moreover, the Commission allowed $29,294 in the expenses of the test year for the cost of a dry hole, which would be the equivalent of increasing the rate base $450,677 when the return is 6½%. See generally R. V. 2657–61, 2667–71, 2723, 2737, 2741, 2769; R. VI, 3401; Appendix D, *infra*.

to be earned in a regulated business must vary with the rates established by the supervising agencies of government, with the result that prophecies, however radiant, may be upset over night by the publication of a lower schedule."

Obviously, such testimony was not of such compelling merit as to require the Commission to disregard the actual legitimate cost of the properties involved.

As indicated by Canadian in its brief (Can. Br. 20–21), the so-called "field" or commodity price of gas is advanced as an alternative "measure of the value" of its leaseholds. Such evidence is clearly subject to the same infirmity as was attributed in the *Dayton* case to evidence of market value. But the vice of the "field price" test lies even deeper. In the Panhandle field the actual and potential production of gas is greatly in excess of needs (R. I, 159). The only markets which are available are located at distant points, and in order to transport gas to these markets it is necessary to construct expensive pipelines.[11] Before embarking on such an undertaking, it is essential that the company constructing the line be assured of an adequate supply of gas. This is accomplished either by acquiring sufficient producing and

[11] E. g., Panhandle Eastern's pipeline represented an investment in excess of $70,000,000. No. 296, this Term. Natural Gas Pipeline Co. had a book cost in excess of $60,000,000 (315 U. S. at 579).

proved gas acreage to insure future supplies, or by entering into long-term contracts with producers of gas under which the parties are bound to the sale and purchase of the gas as long as it shall be produced in paying quantities. Federal Trade Commission Report pursuant to Senate Resolution No. 83, 70th Cong., 1st Sess., Vol. 84 a, pp. 70 *et seq.* In a sense the cost which the pipeline company will be required to pay for the natural gas is determined at the inception of the enterprise. In a setting such as this the concept of a "field" or commodity price is unrealistic.

This Court had occasion to review the situation which obtains in the Panhandle field in *Thompson* v. *Consolidated Gas Co.*, 300 U. S. 55. Without access to pipelines and their distant markets, natural gas produced in the fields had no commercial value other than the extraction of natural gasoline or the production of carbon black (id., pp. 59, 70). In the *Thompson* case, this Court held unconstitutional a Texas statute which sought to compel large pipeline companies to purchase a part of their gas requirements from private producers. There the question of commodity price was not even reached—the pipeline companies did not want the gas at any price.

The value which gas obtains in a market such as the Panhandle or Hugoton field depends exclusively upon the price which the few large pipeline companies are willing to pay. Cf. *United*

*Fuel Gas Co.* v. *Railroad Commission*, 278 U. S. 300; *Dayton Power & Light Co.* v. *Commission*, 292 U. S. 290, 301. Whatever might be the situation where the demand equals or exceeds the supply of natural gas, it is apparent that where the market can absorb only a small fraction of the gas produced the purchaser is in a superior bargaining position. In such circumstances the commodity price, if the law of supply and demand is permitted to operate, will necessarily tend to reflect cost alone. And should competition be sufficiently keen, that cost would probably not carry a 6½% profit.[12] Were Canadian deprived of its markets outside the state, its gas would have little if any value. It would find itself in the same position that its predecessor Amarillo was in—the owner of a vast supply of gas which it could not sell.

Prevailing prices accordingly do not establish a commodity value. When the sales contracts extend for the life of the wells, and vary among themselves, the rates fixed therein merely reflect what the parties to the contract at one time considered to be a fair price. It could currently be either more or less. There is no such thing as a true commodity price unless there are frequent adjustments in price to reflect the changing supply and demand. Moreover, the adoption of a com-

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[12] The Commission, in fixing costs in the instant case, included therein a return of 6½ on the rate base.

modity price would open the door for the establishment of fictitious prices. Over 80% of the total area of the Panhandle fields is controlled by major pipeline companies (300 U. S. at 60). It would be possible for these companies to buy small amounts of gas from independent producers at a high Mcf price and accordingly claim that the price so paid represented the commodity value to which they were entitled in calculating the value of the gas which they produced themselves. "When the pipe-line interests control the only outlets to markets, an arbitrary setting of field prices seems inevitable" (Federal Trade Commission Report No. 84–a, p. 133).

On the other hand, the cost system adopted by the Commission is fair alike to consumers and natural-gas companies. It is readily apparent that if a field such as Panhandle or Hugoton should be discovered near Chicago or Detroit, cost of delivering gas from such field to those cities would be low and gas companies which were incurring higher transportation costs in delivering gas from distant points would be faced with bankruptcy if they were held to the commodity prices.[13] On the other hand the Commission allows the acquisition costs of leaseholds, the delay rentals thereon while they are being held in reserve, well drilling and exploratory costs and all expenses incident to the

[13] It is significant to note that Hope Natural Gas Company purchased gas at prices lower than the cost of producing its own gas. See record in No. 34, Oct. Term 1943, II, 309, 342.

operation of the gas leaseholds, including royalty payments. Thus, the pipeline companies, whose business in the final analysis consists of the interstate sale of gas at wholesale, are assured of the cost of producing the commodity which they sell. Certainly, it may not be said that the action of the Commission in electing to use the cost rather than the commodity value of the gas lacks a rational basis. See *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U. S. 591, 615–616. Indeed, since the Commission has established its policy of allowing cost of production, investors have been lending money at progressively lower rates (see Exhibit 253, Charts Nos. 33 and 34, in No. 296, this Term, R. XIV, 6031, 6033). The average yield on bonds, debentures and notes issued by natural-gas companies has declined from 4.59% in 1936 to 3.11% in 1941 (ibid.).

Finally, if the commodity price rather than cost were adopted by the Commission there would no longer be any necessity for treating the gas business as presenting any peculiar hazards. As a result, the transmission facilities, which constitute the larger portion of the pipe lines investment, would be entitled to a lower rate of return than 6½%.

We accordingly submit that there was no requirement that the Commission, in fixing Canadian's rates for the interstate sale for resale of natural gas, should fix the cost of the gas so sold on a commodity rather than a cost of production basis.

## III

### IN DETERMINING THE ACTUAL LEGITIMATE COST OF CANADIAN'S PROPERTIES, THE COMMISSION PROPERLY DISALLOWED AMOUNTS CLAIMED BY CANADIAN FOR LEASEHOLDS IN EXCESS OF THE COST OF SUCH LEASEHOLDS TO AMARILLO AND ITS AFFILIATES

Assuming that the Commission was entitled to include Canadian's producing and gathering properties at their actual legitimate cost, Canadian nevertheless contends (Can. Br. 21–26) that it was deprived of its constitutional rights by the Commission's failure to include in such cost the full amount of $5,000,000 allegedly paid for such properties as an arm's length "purchase price" therefor. We submit that there was no actual purchase or sale of these properties, but that Southwestern merely transferred them, without any additional investment, from one wholly owned subsidiary (Amarillo) to another (Canadian), in accordance with the intercompany agreement between Southwestern, Standard and Cities Service (see Statement, *supra*, pp. 8–10). Moreover, if, as Canadian urges (Br. 56), the transaction is considered to be the substantial equivalent of a "sale" of the properties by Southwestern to Standard and Cities Service, the other participants in the project, the $5,000,000 represented an advance of a portion of Southwestern's share of the profits of the joint enterprise.

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A. THE PROPERTIES WERE TRANSFERRED BETWEEN WHOLLY OWNED SUBSIDIARIES OF SOUTHWESTERN WITHOUT ANY ADDITIONAL INVESTMENT

Southwestern, through Amarillo, its wholly owned subsidiary, controlled certain gas leases and producing properties in the Texas Panhandle Field, but was unable to obtain an adequate market for the gas (R. I, 402, 459). Southwestern, which was in a poor financial condition, approached Standard and Cities Service with respect to the feasibility of constructing a pipeline from the Panhandle Field to the Denver and Pueblo markets in Colorado (R. I, 520, 559; R. I, 403). Standard was in a position, through the Rockefeller interests, to obtain the Colorado Fuel & Iron Company plant at Pueblo as a large industrial consumer for the pipeline (R. I, 509). Standard also had adequate funds at its disposal, as well as a trained personnel familiar with the construction and operation of natural gas pipelines (R. I, 403). Cities Service, a third party, controlled the retail markets in Denver and Pueblo (R. I, 403) which likewise had to be obtained if the project was to be sufficiently profitable (R. I, 437, 508).

By the intercompany agreement of April 5, 1927, Southwestern, Standard and Cities Service pooled their interests and made arrangements to bring natural gas from the Panhandle Field to the Denver and Pueblo markets. The substance

of the agreement was that (a) Southwestern would furnish gas to the pipeline from its producing properties at "cost"; (b) Standard would invest \$2,000,000 of cash as equity capital and purchase the bonds to be issued to finance the balance of the project, as well as obtain Colorado Fuel & Iron Company as an industrial customer; and (c) Cities Service would have its operating subsidiaries in Denver and Pueblo obtain the requisite natural gas franchises and purchase their entire requirements from the pipeline (R. I, 381–401).[14]

The corporate arrangements under which this pooling of interests was effected may be briefly summarized. Pursuant to the intercompany agreement, Southwestern organized a new wholly owned subsidiary, Canadian,[15] to which were transferred the gas leaseholds and producing properties held by Southwestern's wholly owned subsidiary, Amarillo (R. I, 405). Standard organized a second corporation, Colorado Interstate, to construct and operate the pipeline facilities which would connect with and transport gas from Canadian's facilities to the Denver market and intermediate points, including Pueblo (R. I, 385).

[14] The agreement was not to become effective unless franchises were obtained in Denver and Pueblo which prescribed rates which would make the project "profitably feasible in the judgment" of the three participants, and a schedule of rates which would be satisfactory was specified in the agreement (R. I, 393–394).

[15] All of Canadian's stock was issued to Southwestern, and is carried on Canadian's books at \$1.00 (R. VI, 3523).

Canadian, in order to finance its portion of the project, issued \$11,000,000 of 6% twenty-year sinking fund bonds. These bonds were purchased by Colorado Interstate from the proceeds of \$19,200,000 of its own 6% twenty-year sinking fund bonds which Standard in turn purchased at par (R. I, 496).

As had been agreed, Southwestern caused Canadian to enter into a so-called "cost contract" with Colorado Interstate under which Canadian obligated itself to produce and sell gas for the project at "cost" for a period of twenty years and such further time as Colorado Interstate deemed it profitable to purchase such gas (R. II, 710–797). Under the contract such "cost" included Canadian's operating expenses, as well as interest at 6% and amortization of the principal of all of Canadian's indebtedness over the twenty-year period, such amortization being in lieu of depreciation, depletion and retirements.[16] The contract

[16] An amortization period of twenty years appears to have been specified for the reason that that was the term of the distribution franchises in Denver and Pueblo (R. I, 338). At the end of the test year, 1939, Canadian's "cost" of gas under the contract had included amortization of debt totalling \$9,073,565 (R. VI, 3581). The Commission deducted \$2,134,629 for depreciation and depletion in finding Canadian's rate base (R. I, 161). The interest rate of 6% on Canadian's bonds has not been reduced although the interest on Colorado's bonds was reduced to 2¾% in 1940 (R. II, 632).

further provided that Canadian's "costs" should be decreased by any profits which it might obtain from other sources, including local sales permitted by Colorado (R. I, 393; R. II, 719–732).

Since Canadian, under the "cost" contract, would not have any profits available for dividends (R. III, 1436), it was implicit in the intercompany agreement that the three participants, Southwestern, Standard, and Cities Service, would receive their profits from the joint enterprise in the form of dividends on their stock holdings in Colorado Interstate. Pursuant to the agreement, Colorado Interstate issued $2,000,000 par value of 6% preferred stock and 1,250,000 shares of no par common stock (R. I, 395–396). 15% of the common stock was allotted to Cities Service as its share of the profits of the joint enterprise (R. I, 396). The remaining 85% of the common stock and all of the preferred stock was divided equally between Southwestern and Standard. For its share (50%) of the preferred stock and its share ($42\frac{1}{2}$%) of the common stock, Standard paid $2,000,000 in cash (R. II, 626).[17] In addition to 50% of Colorado Interstate's preferred stock and $42\frac{1}{2}$% of its common stock, Southwestern received $5,000,000 in cash from the proceeds of the $11,000,000 of bonds issued by Canadian, which bonds were to be amortized over twenty years as

[17] This was the only equity capital actually invested in the entire enterprise.

part of the "cost" of gas to Colorado Interstate. This $5,000,000 is the alleged "purchase price" of the gas leases and producing properties of Southwestern's subsidiary (Amarillo) which Canadian contends the Commission should have allowed in determining its rate base.

Upon the foregoing facts, we submit that the Commission was entirely justified in concluding that, from the standpoint of Southwestern and its wholly owned subsidiaries, no true purchase and sale occurred, and the $5,000,000 represented no additional investment in the properties. We discuss below our view that the $5,000,000 in actuality represented an advance of a portion of Southwestern's profits in the joint enterprise; but however that may be from the standpoint of the relationship between Southwestern and its partners, it seems obvious that as between Southwestern and its subsidiaries there was no more than a paper intercompany profit.[18] Had Canadian never been

[18] The $5,000,000, although reflected on Amarillo's books largely in the form of credits, was not in fact even paid to Amarillo by Canadian. Prior to Canadian's organization, Standard advanced $5,000,000 in cash to Prairie Oil & Gas Company, a holding company affiliated with Southwestern, and Prairie used the sum in discharging certain obligations of Southwestern and Amarillo, in advancing $1,000,000 to West Texas Gas Company, another Southwestern subsidiary, and in furnishing $310,000 to Amarillo (R. V. 2937; 2932–35). Canadian, upon its organization, repaid the $5,000,000 to Standard with 6% interest, out of the proceeds of its bonds sold to Colorado Interstate.

organized, and instead Amarillo had placed the bond issue on the properties and either turned over $5,000,000 of the proceeds to its parent or repaid Standard the same sum in satisfaction of a loan, there would be no possible basis for contending that the payment represented an investment by Amarillo which should be allowed as part of the rate base. Cf. *Northwestern Electric Company* v. *Federal Power Commission*, 321 U. S. 119. The circumstance that for convenience in segregating the properties which were to be devoted to the project it was decided to place them in a new company—Canadian—likewise a wholly owned subsidiary of Southwestern, can have no effect upon the reality of the transaction.[19] In either event, Southwestern would merely have received $5,000,000 as part of the proceeds of a bond issue secured by a mortgage on properties owned by one of its wholly-owned subsidiaries. No part of this $5,000,000 was, or could be, turned into an investment in the properties by the device of shifting them over to a new wholly owned company before having the mortgage and bond issue executed.

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[19] Testimony of one of Canadian's witnesses (R. I, 521) shows that the decision not to place the properties in the new pipeline company (Colorado Interstate) was due to Standard's reluctance to be known as having an interest in a company owning land in Texas. The decision having thus been made to leave the ownership of the properties in Southwestern, it is obvious that mere considerations of corporate convenience must have determined in which of Southwestern's pockets they should be kept.

The unreality of the so-called "payment" is emphasized by the treatment accorded to the transaction on the books of the companies involved. The difference between the $5,000,000 "payment" and the cost of the properties—a difference of more than $3,000,000—was recorded by Amarillo on its books[20] as "paid in surplus" (R. V, 3046) and by Canadian, until 1939, as "appreciation" (R. V, 2630-2632), thus establishing that at the time the excess was regarded by the participants as too lacking in substance to be treated as a valid cost to Canadian or as a *bona fide* profit to Amarillo. In fact, in 1935 one of the principal executives of the Southwestern holding company group described the excess as "purely an inter-company profit" (R. I, 559). The "profit" disappeared in the consolidated tax return of Southwestern and its subsidiaries, including Amarillo and Canadian, and none of the companies paid any income tax as a result of the so-called "sale" (R. V, 2638).[21]

[20] This in spite of the fact that the "payment" was not actually made to Amarillo. See footnote 18, *supra*.

[21] While Canadian intimates (Can. Br. 60) that the effect of the elimination of taxable profit upon its depreciation and depletion base may in the long run result in its being required to pay "more, rather than less, Federal income taxes," it is to be noted that the Commission, in determining Canadian's income available for a fair and reasonable return, allowed all of Canadian's 1939 tax expense, finding it to be ample (R. I, 297).

Contrary to Canadian's contention (Br. 67), there is nothing in *A. T. & T. Co.* v. *United States*, 299 U. S. 232, inconsistent with the treatment here accorded to the intercompany profit. Because of the stipulation filed by the Federal Communications Commission in that case, the Court had no need to, and did not, decide the question whether the price paid in an acquisition of property may be disregarded merely because the parties to the transaction were affiliated. Here, the issue is whether any portion of the $5,000,000 advance did in fact, and "after a fair consideration of all the circumstances, * * * represent an investment" (299 U. S. at 241). The *A. T. & T.* case, however it may control the treament of the investment once its existence is determined, is of no aid in determining whether in fact it did exist.[22]

Here, the Commission has found that the "payment" did not in reality represent any increase in investment in the properties. The true character of the transaction is discussed in detail under the following heading.

[22] The decision of the three-judge stattutory court in *New York Telephone Co.* v. *United States*, 56 F. Supp. 932, is likewise of no aid to Canadian's argument. Apart from the question whether that case was correctly decided, it involved an entirely different factual and statutory situation, including the significance of the company's contention that its accounting had been in accord with, if not required by, the regulations of the Interstate Commerce Commission applicable to it at the time.

B. FROM THE STANDPOINT OF STANDARD AND CITIES SERVICE THE $5,000,000 WAS AN ADVANCE TO SOUTHWESTERN OF A PORTION OF ITS SHARE IN THE PROFITS OF THE JOINT ENTERPRISE

In its statement of the questions presented, upon which the writ of certiorari was granted in No. 380, Canadian has chosen to treat the $5,000,000 "payment" as "the amount actually invested by Canadian in its original acquisition of production properties" (Question 3; see Can. Br. 3). So regarded, the excess disallowed by the Commission was, as we have seen, merely a paper profit in a transaction between wholly owned subsidiaries of the same parent. Doubtless recognizing the weakness of its position as thus originally presented to the Court, Canadian insists that the proper treatment of the "payment" is not as an investment by Canadian at all, but as the proceeds of an arm's length purchase of the properties by Cities Service and Standard from Southwestern. It states (Can. Br. 64) "that the real transaction was between non-affiliated parties [Southwestern on the one side and Standard and Cities Service on the other; see Can. Br. 56] and that the purchase price was agreed upon only after prolonged arm's length bargaining between non-affiliated parties." It emphasizes that there were no negotiations between Canadian and Amarillo, and that the $5,000,000 was paid before Canadian was even organized (Can. Br. 11, 59).

It may be conceded for purposes of our argument that Southwestern bargained at arm's length with Standard and Cities Service. But this does not make of the transaction a sale of producing properties by Southwestern. Southwestern owned the properties before the intercompany agreement, and it continued to own them afterwards, subject only to Canadian's obligation to furnish gas to the project at "cost." Subject to that obligation it still owns them. Title to the properties was merely transferred from one of its wholly owned subsidiaries to another.

True, under the intercompany agreement Southwestern's properties held by Canadian were subject to a "servitude" in favor of the joint project in which Southwestern was a participant. But this did not convert the transaction into a "sale" of the properties. Rather, Southwestern, as its contribution to the project, agreed to commit its properties to the furnishing of gas to the project at "cost". This was Southwestern's contribution to the enterprise, and its only contribution. In consideration for this contribution Southwestern received its share of Colorado Interstate's stock—50% of the preferred and 42½% of the common—and a cash advance of $5,000,000 (R. I, 392). Standard, on the other hand, as its contribution, put up $2,000,000 in cash as equity capital, and

purchased the bonds which were issued to finance the balance of the project (R. I, 496).[23]

Accordingly, if the transaction is to be viewed, as Canadian urges (Can. Br. 56, 64), from the standpoint of the three participants in the joint enterprise, the $5,000,000 clearly represents, not the purchase price paid by the project for Southwestern's properties, but rather a portion of Southwestern's share of the profits of the project—a share of the profits to exactly the same extent as its anticipated dividends on its allotment of Colorado Interstate's preferred and common stock. It is not, and could not reasonably be, suggested that the dividends obtained by the participants on their Colorado Interstate stock should be included in the rate base for the purpose of determining the reasonableness of the rates to be borne by the consuming public; and we submit that no greater basis exists for including a cash advance of such profits by one of the participants to another. That Southwestern and Standard may have been at arm's length in bargaining as to

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[23] The advance to Southwestern first took the form of a short-term loan at 6%. This was repaid by Canadian upon its organization out of the proceeds of its 20-year 6% bonds which it sold to Colorado Interstate. Standard, in turn, by buying Colorado Interstate's 20-year 6% bonds, furnished Colorado Interstate with the funds with which to buy Canadian's bonds (R. I, 496). In the last analysis, therefore, Standard advanced the $5,000,000 to Southwestern on a 20-year sinking-fund basis, at 6% interest.

how much Standard would advance can have no effect upon the nature of the transaction between them.

Regarded from the standpoint of the three participants, as Canadian urges, the case is in essential respects similar to that presented in *Niagara Falls Power Company* v. *Federal Power Commission*, 137 F. (2d) 787 (C. C. A. 2), certiorari denied, 320 U. S. 792. There, two unaffiliated groups, the Schoellkopfs and the Stetsons, owned and operated hydro-electric projects at Niagara Falls, New York. In order to utilize all the water being diverted by the two projects through the higher head and more efficient Schoellkopf plant and thus produce more power during World War I, the New York State Legislature, at the urgent request of the Federal Government, passed a special act authorizing the Schoellkopf companies to consolidate with the Stetson company to form a single "new" corporation.[24] The special act further provided that the new corporation could issue stock in exchange for the stock of the underlying companies in amounts not exceeding the aggregate of the book value of the latter. The consolidated corporation subsequently obtained a

[24] Diversions from the Niagara River for power purposes on the United States side were limited to 20,000 c. f. s. under the International Boundary Water Treaty of 1910 (36 Stat. 2448, 2450) and this amount of water was being diverted by the Schoellkopf and Stetson projects under special permits issued by the Secretary of War.

license from the Federal Power Commission under the Federal Water Power Act of 1920, and in determining the actual legitimate cost of the combined properties the Commission found substantial "write-ups" on the books of the predecessor companies which had been transferred to the books of the new company in the consolidation. The Commission "went behind" the consolidation and disallowed such "write-ups". Upon review of the Commission's order, the company, relying upon the absence of any affiliation between the original Schoellkopf and Stetson companies, contended that its stock issued in exchange for the stock of the predecessor companies had been issued in an arm's length transaction, and that since the amounts transferred to the consolidated company's books were fully supported by the then "value" of the underlying properties, such amounts should have been allowed as part of the cost of the properties.

In rejecting this contention and sustaining the Commission's order, the court, in an opinion by Judge Learned Hand, held (137 F. (2d) at 793-794):

> "* * * The three companies did not sell their properties to the petitioner, and the petitioner did not buy of them. We do not mean merely that the form of the transaction was not a sale—we should not stand on that—the substance also was not a sale. The properties had been held by two groups of persons: 'Stetson' and 'Schoellkopf' who

> combined their interests into one company which thereafter they owned jointly. The allotment of the shares as between the two groups was doubtless the result of genuine competition; presumably it followed the relative values of the properties. But all competition, all 'arms-length' bargaining, stopped there; neither party had any interest to reduce the nominal capitalization. * * * In short, while it may be tolerable to allow a buyer to capitalize the purchase price he may have paid, even though that has been computed upon the assumed continuity of rates which were higher than they should have been, there is surely nothing to be said in favor of allowing two companies mutually to pool their interests, and from that time forward to treat as vested the values they happened then to have."

Canadian contends (Br. 68) that the *Niagara Falls* case is not in point because there no money changed hands and in the end "each of the so-called sellers owned a portion of the combined assets". It is true that here Colorado Interstate, which was jointly owned by the three participants in the enterprise, did not acquire title to the properties as in the *Niagara* case, such title being vested in Canadian, the wholly owned subsidiary of one of the participants, Southwestern. However, this merely points up the fact that, as we

have seen, the actual transfer of the properties in this case was from one subsidiary of Southwestern (Amarillo) to another (Canadian), without any additional investment. The weakness of Canadian's position is emphasized by the fact that to avoid treatment of the excess as a properly disallowable intercompany profit, it must argue that the properties were "sold" not to Canadian but to the project, and that it must deny the very same conclusion to escape the authority of the *Niagara* case. If the transaction was in reality a sale to the project, the technical retention of title in Canadian should not be permitted to divert attention from the substance of the situation.

Nor does the "payment" of $5,000,000 to one of the participants serve to distinguish the cases. As we have seen, in spite of its form, this "payment" was in reality no more than a loan, received through the issuance of Canadian's bonds, which would be amortized over a twenty-year period as a "cost" in Canadian's sale of gas to Colorado Interstate. To the extent of this amortization, Colorado Interstate's "cost" of gas under the contract would be increased, and its profits available for dividends on its stock correspondingly decreased. From the standpoint of the other two participants, the loan was no more than an advance payment of Southwestern's share of the

anticipated profits. The amount of the advance has no greater bearing on the extent of Canadian's or Southwestern's investment in the properties than if Southwestern had bargained, equally at arm's length, with its banker for a loan on the strength of its prospects of profit from the venture.

Finally, we respectfully submit that in such an area as this, where proper treatment of an item of alleged "cost" depends upon the factual significance to be given to a large mass of related details in a complex intercorporate arrangement, the judgment of the Commission as the agency charged by Congress with the responsibility for making the essential factual determinations underlying the fixing of just and reasonable rates should be given peculiar weight by the courts. As this Court has many times held in comparable fields, on such a question the administrative judgment should be left undisturbed if only it has warrant in the record and a rational basis in law. Cf. *National Labor Relations Board* v. *Hearst Publications*, 322 U. S. 111, 131; *Dobson* v. *Commissioner*, 320 U. S. 489. We submit that in this instance there is at the very least no such infirmity in the Commission's determination of the true nature of the transaction as would justify substitution of the judgment of the courts for that of the Commission.

## IV

### THE COMMISSION PROPERLY DETERMINED THE AMOUNT OF THE REDUCTIONS IN PETITIONERS' REGULATED RATES BY AN ALLOCATION OF COSTS BETWEEN REGULABLE AND NONREGULABLE SALES

In objecting to the Commission's allocation of cost of service between the regulable and nonregulable sales, Canadian and Colorado Interstate contend that the Commission was required, as a matter of "jurisdiction", to make an allocation of their physical properties (Can. Br. 26–30; and Col. Br. 27–41). Petitioners further contend that the Commission should have adopted the allocation proposed by their witnesses instead of that presented by the Commission's engineer (Can. Br. 76–83; Col. Br. 41–56). We submit that there is no merit in these contentions. The Act vests the Commission with administrative discretion in the matter of allocation, and since the allocation of cost of service which the Commission here adopted was "a working one suitably adapted to the particular circumstances," it was properly affirmed by the court below (R. VIII, 5087).

#### A. THE COMMISSION HAS ADMINISTRATIVE DISCRETION TO ADOPT ANY METHOD OF ALLOCATION WHICH IS REASONABLE AND APPROPRIATE

There is no basis for petitioners' contention that the Commission was required to make an allocation of their physical properties, and, there-

fore, erred in determining the reasonableness of their interstate wholesale rates upon the basis of an allocation of the cost of service. The Natural Gas Act does not prescribe any method of allocation which the Commission must follow in determining the reasonableness of the interstate wholesale rates of a natural gas company.[25] Congress thus left the matter of allocation to the expert judgment of the Commission, subject to judicial review in the event of an abuse of its administrative discretion in this regard.

The sole purpose of an allocation between the regulable and nonregulable sales of a natural-gas company is to aid the Commission in its determination of the reasonableness of the return which the company is receiving from its regulated rates and to enable the court on review to determine whether a prescribed reduction in such rates violates any constitutional standards. In reviewing such orders this Court has not undertaken to prescribe any particular formula or method of allocation. As Mr. Justice Brandeis observed in *Groesbeck* v. *Duluth, S. S. & A. Ry. Co.*, 250 U. S. 607, 614, "it is much easier to reject formulas presented as being misleading than to find one apparently adequate." He also noted that the determination of the formula to be adopted in a

[25] Nor does the Act by its terms require that a formal allocation be made. This question is discussed in greater detail in our brief in No. 296, this Term.

particular case "presents a question, not of law, but of fact," and as Mr. Justice Douglas said in the recent case of *Butler Brothers* v. *McColgan*, 315 U. S. 501, 507, "one who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extra-territorial values being taxed."

The decisions of this court in the *Minnesota Rate Cases*, 230 U. S. 352, and in *Smith* v. *Illinois Bell Telephone Company*, 282 U. S. 133, do not support petitioners' contention that the Commission, as a matter of jurisdiction, had to make an allocation of their physical properties. In those cases, State agencies were undertaking to regulate the intrastate rates of utilities which were also engaged in interstate operations, the latter being constitutionally immune from State regulation. The regulation of the interstate wholesale rates of natural gas companies under the Natural Gas Act does not present such a constitutional problem, since Congress, if it so desired, could regulate the intrastate rates of such companies which "affect" their interstate rates and operations. In any event, an allocation of properties is merely a step in the determination of the costs (including return) properly allocable to the several classes of service of a company. As the Commission here observed, "all that can be accomplished by an allocation of physical properties can be attained by allocating costs including return" (R. I, 175).

It is thus apparent that the Commission is not precluded by the Constitution, the Act, or the prior decisions of this Court, from making a proper allocation of costs, including return, without first taking the preliminary step of allocating the physical property.

B. THE COMMISSION'S ALLOCATION OF COST OF SERVICE WAS REASONABLE AND APPROPRIATE

In arriving at the amount of the ordered reductions in petitioners' interstate wholesale rates, the Commission made an allocation of the cost of service of each petitioner, including in such cost the fair return on the rate base, and determined the excess of revenues over costs for intrastate sales, interstate direct industrial sales, and interstate sales for resale (R. I, 176–177). In making such allocation of costs, the Commission adopted the so-called "demand and commodity" method,[26] which had been presented by its staff witness Lyon, a gas engineer of wide experience (R. IV, 2375–80). We submit that the Commission's action in this regard was an appropriate and reasonable exercise of its administrative discretion in the circumstances.

The amount of gross revenues which petitioners derived from each of their customers was definitely known and undisputed. Accordingly, the

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[26] See *Arkansas-Louisiana Gas Company* v. *City of Texarkana*, 17 F. Supp. 447, affirmed, 96 F. (2d) 179 (C. C. A. 8), certiorari denied, 305 U. S. 606.

only problem involved in a determination of the reasonableness of petitioners' interstate wholesale rates was to arrive at the portion of petitioners' operating expenses, including depreciation, depletion, taxes, exploration and development costs, which was properly allocable to each customer. Inclusion of the fair return of 6½% in the costs being allocated, gave the amount of revenue, in excess of costs and a fair return, being derived from each of petitioners' customers. Having thus determined the amount of excess revenues being derived from the interstate wholesale customers, petitioners were ordered to reduce their rates to such customers accordingly.

The method of allocation of costs, including return, which was thus presented by the staff engineer and adopted by the Commission, may be briefly summarized:

The total cost of service includes all costs allowed by the Commission, i. e., all operating expenses, exploration and development costs, taxes, depreciation, and a return of 6½% on the rate base.[2] Such total cost was separated into

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[2] The total cost of service found by the Commission was $3,776,203, or $369,345 more than that used by witness Lyon, due principally to the Commission's allowance of a 6½% instead of a 6% return, and the Commission's increased allowances for depreciation, depletion and rate case expenses. These adjustments are tabulated in Schedules 1 and 2 of Appendix B, *infra*.

three classes, viz., "volumetric", "capacity" and "distribution" costs (R. I, 175; R. IV, 2317).[28] The volumetric costs were allocated to the customers on an annual Mcf basis, i. e., in the ratio that the sales to each customer in the test year 1939 bore to the total sales to all customers in that year. The total capacity costs were allocated to the customers in the ratio that the Mcf sales to each customer on the system peak day of February 9, 1939, bore to the total sales to all customers on that day (R. I, 175–176; R. IV, 2317–2319, 2381–2384).[29] The distribution costs, totaling $98,137, consist of two general classes: (1) depreciation, taxes, and return on investment in metering and regulating equipment

[28] The Commission characterized the "volumetric" or "commodity" costs as "variable costs * * * that vary proportionally to the output or volume of sale." It characterized the "capacity" or "demand" costs as "fixed costs * * * which do not vary with volume of sales" (R. I, 175–176).

[29] In allocating the capacity costs, domestic and commercial gas was treated as a class, and industrial gas, both direct and resale, as a separate class. It was then necessary for the expert to allocate the costs between direct and resale industrial sales. The capacity costs allocable to the industrials as a class were distributed to the individual industrial customers on a non-coincidental peak basis, i. e., in the ratio that each industrial customer's maximum 24-hour deliveries on any day in 1939 bore to the total of the maximum 24-hour deliveries of all industrials. This method produced substantially the same result as would have been obtained by using the ratio of sales on the single peak day of February 9, 1939, for allocating the costs as between direct industrials as a class and resale customers as a class (R. IV, 2438).

through which gas is delivered at individual stations to each customer, and (2) operating, maintenance and general expenses incurred in operation of such metering and regulating stations. The first group was allocated to each customer in the ratio which the investment for each customer bore to the total investment in such facilities to serve all customers. The second group was allocated on the basis of the number of stations (R. IV, 2335–2337, 2384; R. V, 2442–2443).

All costs related to the production system (including return, depreciation and depletion on leases and wells) were treated as volumetric, and a well-head unit cost developed per Mcf. These costs were allocated to customers in proportion to the number of Mcf's delivered to each customer in the year 1939. Similarly, a unit cost per Mcf was developed for gathering-system costs, which was apportioned to customers on an annual Mcf sales basis (R. IV, 2329; 2382; See Schedule F of Appendix B, *infra*). The residual refining credit was separately determined for each market, because residual refining operations are carried on in three separate gasoline plants, each of which processes gas transmitted to one of the three markets, viz., (1) the market served intrastate within Texas, (2) the markets served from the Denver pipeline, and (3) markets served by Natural Gas

Pipeline Company (R. IV, 2331, 2382–2383; see Schedule 1 of Appendix B, *infra*).

The transmission costs of the Denver line, totaling $2,241,432, were separated between volumetric costs ($727,908) and capacity costs ($1,513,524) (R. IV, 2333, 2383–2384; see Schedules 1 and 4 of Appendix B, *infra*). Briefly, all Denver line transmission costs were classified as capacity costs except that (1) all compressing system supplies and expenses, maintenance of compressing system equipment and accruals for depreciation of compressing station equipment were classed as volumetric, and (2) 50% of the return and income taxes on the Denver line, and operating labor on the compressing system, were classed as volumetric, and 50% as capacity (R. IV, 2333). The rental of $230,507 paid by Canadian to Texoma Natural Gas Company for the use of the latter's line to transport gas to Gray, Oklahoma, for delivery to Colorado for resale to Natural Gas Pipeline Company, was allocated entirely to such sale (R. IV, 2317, 2384).

The propriety of the Commission's action in adopting the foregoing method of allocation presented by its staff engineer is further apparent from a brief consideration of the inherent defects in the two methods of allocation which petitioners submitted.

Under petitioners' first method the cost of service to the wholesale customers was determined on

the basis of what it would have cost to construct and operate a hypothetical substitute pipeline to serve only such customers.[39] Under this method all the gas sold to industrial customers during off-peak periods would be given free transportation through the pipeline. Yet, as petitioners' witness admitted, a pipeline to serve only the wholesale customers would never have been built (R. II, 1089–90; 1098–1101; R. III, 1743–1744).

Petitioners' second method was equally unsound. Under this method the total cost of service would be allocated between the wholesale customers and the direct industrial customers on the basis of the ratio between (a) the cost of constructing and operating a pipeline of sufficient diameter to serve only the wholesale customers and (b) the cost of constructing and operating a larger pipeline having sufficient diameter to meet the requirements of all customers including direct industrials (R. IV, 2268–2273) (Exh. 316, pp. 14–22; Tr. 24,264–24,272). This method thus assumes, for purposes of allocation, that only the wholesale gas flows through the diameter nearest the center of the pipe and only the direct industrial gas flows through the balance of the pipe. Since the unit cost of constructing pipeline capacity decreases as the diameter of the pipe increases, it is clear that this method would assess

[39] R. II, 1086; R. III, 1469, 1734; R. VI, 3565; R. III, 1742; R. IV, 2144; R. VIII, 4860–4861; R. IV, 2192.

against the resale customers the initial and more costly portion of the installed capacity.[1] Thus, petitioners' witness Rhodes admitted that under this method, when 61.8% of the gas flowing through the pipeline is taken by the wholesale customers, there should be allocated to them not 61.8% of the transmission costs, but 83.5%.[2] Petitioners' second plan of allocation also assumes that the first compressor engine installed at each compressor station is entirely used to pump resale gas and therefore that all of its cost should be allocated to such resale business, the cost of only the additional units at each station being allocated between the resale and direct sale business (R. IV, 2272). Combining these assumptions with some reproduction cost estimates, petitioners' witness charged the wholesale business with 70% to 95% of the cost of compressor stations (R. IV, 2273-2275), although exhibits introduced by the same witness show that at least three of the five compressor stations on the Denver pipeline were

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[1] Petitioners' witness, Rhodes, testified: "The cost of a pipe line does not vary in direct proportion to its capacity but the cost does vary substantially in direct proportion to the diameter" (R. IV, 2270).

[2] Witness Rhodes testified: "A line of 61.8 per cent capacity has, as shown on Chart II attached, a diameter of 83.5 per cent of full diameter, referred to as the diameter ratio. Accordingly, the resale gas should bear 83.5 per cent of the full cost of that part of the trunk line in which its quota is 61.8 per cent of capacity" (R. IV, 2270).

installed to enable petitioners to deliver gas to direct industrial customers on peak days.[33] Under this method, none of the cost of these three compressor stations should be charged to the resale business. Finally, it is to be noted that petitioners' second method would result in a cost of only 7.58¢ per Mcf being assigned to gas sold to direct industrials, for which Colorado receives average revenues of 13.39¢ (Ex. 140, sum of lines 8 and 11, column 7 divided by sum of lines 8 and 11, column 11; Tr. 13284), or a profit margin of 76% over such purported cost.

We accordingly submit that the Commission did not abuse its administrative discretion in adopting the method of allocation presented by its staff engineer and rejecting the methods urged by petitioners.

C. PETITIONERS' OBJECTIONS TO THE COMMISSION'S METHOD OF ALLOCATION OF COST OF SERVICE ARE WITHOUT MERIT

In addition to those mentioned above, Colorado Interstate advances several objections to the Commission's allocation (Col. Br. 41–53), in which

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[33] For example, in Exhibit 316 witness Rhodes states that the peak day demand of the resale business on January 24, 1940, was 67,783 Mcf (R. IV, 2268), while in Exhibit 66 (R. II, 1109) he shows that the capacity of the line as it existed in 1929, with only the Bivins and Canyon Stations in operation, was 80,000 Mcf, or more than enough to take care of the peak demands of the resale business in 1940. Since the present rated capacity of the Denver line is now 105,000 Mcf, it is clear that the additional compressor stations were constructed since 1929 to take care of the direct industrial business.

Canadian joins (Can. Br. 73). We submit that these objections lack substance.

1. *Priority of Service.*—Contrary to Colorado's contention (Col. Br. 42–45), it is clear that the Commission gave full effect to contractual priority of resale gas over direct industrial sales to the extent it was actually exercised during the test year. Under the Commission's method, volumetric costs were apportioned on the basis of the total volume of gas taken by each customer during the test year and capacity costs were apportioned on the basis of each customer's actual receipts on the system peak day. Thus, the method fully reflected all actual curtailments of load to each customer throughout the year and on the peak day.

Moreover, the record shows that interruptions and curtailments of direct industrial customers are so slight that the Commission might well have allocated to the direct industrial customers their full volumetric share of all costs of the Denver line amounting to 46.4% of the gas delivered from such line in 1939, instead of allocating only 40.5% of such costs (R. IV, 2319). The Commission's engineer testified that sufficient capacity has been installed to provide uninterruptible service to the industrial customers (R. V, 2439–2440), and that practically all of petitioners' customers have received almost continuous service as a result of petitioners' policy of increasing the capacity of

the system as the anticipated demands of all customers increased (R. V, 2439–2440).[34]

Petitioner's statement (Col. Br. 8, 9, 42) that priority and preference provisions in contracts had operated in favor of the domestic customers on 40 different occasions, is inaccurate. The record shows (R. II, 1025–1028) that during the 12½-year period from the commencement of operations on June 19, 1928, to December 31, 1940, natural-gas deliveries from the Denver pipeline were reduced or completely interrupted only 15 times. The Company calculates its "forty occasions" by multiplying each date of interruption by the number of customers who were interrupted (R. II, 1025–1028).[35] The record shows that de-

[34] For example, Colorado Portland Cement Company, a direct industrial customer, is served under an agreement (R. II, 955) which provides that service will be supplied during the months of November to February, inclusive, only when the Colorado Company "has gas and capacity available." Yet, deliveries to this customer have been reduced only 117 hours during the entire ten-year period of service, and service has been completely interrupted only 36 hours, due to a break in the branch line to such customer's plant. At all other times, the Cement Company has received full and complete service (see Appendix C, *infra*).

[35] For example, R. II, 1027 shows that service to Colorado Wyoming Gas Company and Atchison, Topeka and Santa Fe R. R. Co. was interrupted on June 1, 1937, and June 2, 1937, for 32 and 49 hours, respectively. This was one consecutive period of interruption. Petitioners call this "two occasions." Again, R. II, 1027–1028 shows that service to Arkansas Valley Natural Gas Company, Citizens Utilities Company, American Crystal Sugar Company, Atchison, Topeka and

spite physical failure of facilities and high demands, full and complete service has been rendered to customers from 99.79% to 99.99% of the time they were connected to the Denver pipeline. (See Appendix C, *infra.*)

It is clear from the testimony of Company engineer Rhodes, who participated in designing the Denver line, that such line was originally designed for carrying the loads of both the domestic and industrial customers (R. IV, 2260). As additional capacity was required to meet the peak loads of both classes of customers, additional compressor facilities have been installed. The daily capacity of the Denver pipline was 80,000 Mcf in 1929 and 1930 (R. II, 1109). The actual peak-day deliveries to resale customers 10 years later, in January 1940, from that line were 67,783 Mcf (R. IV, 2269) and would have been only 79,835 Mcf at an assumed mean temperature of 15 degrees below zero, according to petitioners' estimates (R. II, 2269). Thus, in 1940 the peak-day load of all resale customers was less than the capacity of the line as it existed in 1930. During the ten-year period 1930–1940 two of the original compressor stations on the pipeline were enlarged

Santa Fe R. R. Co., and Veterans Administration Facility were interrupted for periods varying from 8 to 13 hours on September 9, 1937, due to a washout on the Arkansas Valley lateral which serves all these customers. In their brief, petitioners designate this single interruption of service to five customers as "five occasions."

and three more compressor stations were added,[36] thereby enabling petitioners, on the peak-day in January 1940, to deliver not only 67,783 Mcf to resale customers, but in addition 47,343 Mcf to direct industrial customers, or a total of 115,126 Mcf (Exh. 316, p. 12; R. IV, 2269). It is apparent, therefore, that if petitioners had not intended to deliver gas to direct industrial customers on peak days, they would not have installed such additional compressor facilities between 1930 and 1940.

2. *Transmission Line as a Unit.*—There is also no merit in petitioners' contention that the Commission erred in treating the Denver line and its laterals (branch lines) as a unit, because certain laterals, metering stations and associated equipment are used exclusively for making either regulable or nonregulable sales and the balance of the property is used in common in varying degrees by both classes of business (Col. Br. 45–47; Can. Br. 76–83).

With respect to metering stations and associated equipment used exclusively in the service of individual customers, the return, depreciation, and taxes on the investment in such equipment, as

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[36] Allowance was made by the Commission in petitioners' rate bases for future capital additions, including an additional compressor station to be installed on the Denver pipeline, making a total of six stations, and thereby allowing for the cost of further increases in capacity of the line (R. I, 162–164).

above stated, were allocated in the ratio that the investment for each customer bore to the total investment in such facilities. Thus, such costs were assessed on the basis of use by each customer.

While ~~the laterals~~ were not segregated, it is apparent from petitioners' own evidence that if the Commission had made such a segregation more costs would have been assigned to the direct industrial customers, since the laterals are used more extensively by the direct industrial customers than by the resale customers.[37]

Moreover, the Commission's treatment of the Denver line as a unit was reasonable and is supported by substantial evidence. In *Wabash Valley Electric Co. v. Young,* 287 U. S. 488, 497, this Court held that "normally" the unit for rate-making purposes is "the entire interconnected operating property of a utility used and useful for the convenience of the public in the territory served, without regard to particular groups of consumers or local subdivisions." That case approved an allocation apportioning the average generating

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[37] According to company witness Rhodes' Exhibit 316, Statement No. 10-B (Tr. 24,308), 67% of the gas delivered through the laterals on the peak day of 1939-1940 winter was sold to direct industrials. Mr. Rhodes apportioned 50% of such laterals to Colorado Interstate's regulable sales and 50% to its nonregulable sales, thereby demonstrating that the most the Company has claimed is that such laterals are used 50-50 by both classes. The Commission allocated only 40.5% of the transmission costs (including laterals) to the direct industrial or nonregulable sales (see Appendix B, *infra*).

and transmission costs of a large interconnected electric system which operated in a territory comprising thirteen counties and sold electric current to approximately fifty cities and towns and to affiliated utilities for subsequent distribution in many other towns and cities. Under such method, there was allocated to the city of Martinsville a proportionate part of the total value of the general generating and transmission system "on the basis of the ratio of actual sales of Kw. H. to Martinsville and its consumers to the total sales of Kw. H. by plaintiff during the year 1929" (Id., 499).

The Denver line is 340 miles in length, having its most important and one of its indispensable markets in Denver at the very end of the line. The pipeline admittedly (Col. Br. 44) would not have been built and the various communities and customers along the route of the line would not be receiving natural-gas service from the project, were it not for the Denver resale market and the Colorado Fuel & Iron Company's direct industrial market (R. I, 142, 437).

Some 20,904,344 Mcf, or 98% of the total 21,364,223 Mcf delivered from the Denver line in 1939, was delivered in the State of Colorado after the gas had been transported along the main pipeline 200 miles, and after passing through at least three of the four compressor stations at such time (R. II, 1079, 693; R. IV,

2319). Moreover, the volumetric load center of the Canadian-Colorado Interstate pipeline system is at a point approximately half way between Denver and Pueblo (R. V, 2427). Accordingly, it was reasonable to determine the transmission costs for the pipeline as a whole and not on a mileage demand basis. Cf. *Columbus Gas & Fuel Company* v. *Public Utilities Commission*, 292 U. S. 398, 408–409. Significantly, Colorado Interstate's existing rate structure gives recognition to the propriety of this procedure, because its basic rates for gas sold at the Pueblo, Colorado Springs, and Denver "city gates" are identical (Exh. 262, Table R–9, Sheet 1; Tr. 23,514), although gas delivered to Denver is transported 110 miles farther and through one more compressor station than gas delivered to Pueblo (R. II, 693). As the Commission engineer testified, the various parts of the Denver transmission system are "so interwoven that it is not reasonable to segregate" them (R. IV, 2399).

Certain incidental contentions which petitioners advance in this connection may be briefly noted. Canadian's contention that the Commission made an erroneous allocation of costs in determining the cost of service for intrastate gas sold by it from the Denver line to Amarillo Oil Company for resale to the towns of Dalhart, Hartley and Texline, Texas (Can. Br. 80–81) also lacks substance. Only 378,912 Mcf of gas was sold for